

# **Credit Counseling Compliance Project**

May 15, 2006

## **Introduction**

This report summarizes the Internal Revenue Service Credit Counseling Compliance Project results to date. The Project focused on abuse by tax-exempt credit counseling organizations by establishing an on-going program to ensure continuous compliance with the tax laws through education, examinations, a comprehensive determination process, and a public awareness program.

## **Background**

In the early 1990's, the IRS approved approximately 200 applications for tax exempt status from credit counseling organizations. That number increased almost 400 percent in the late 1990s and early 2000s. At the same time, media reports and referrals alleged improper activity by these organizations. As a result, the IRS became increasingly concerned about the activities of consumer credit counseling organizations.

Traditionally, credit counseling agencies were non-profit organizations that relied on contributions and small fees from consumers to cover the operating costs of providing advice, debt counseling, and limited debt management plans to consumers who had trouble paying their credit card bills. Initially granted tax exemption under Internal Revenue Code section 501(c)(3) because they promised to provide educational and counseling services to financially strapped consumers trying to get out of debt, many of these organizations have changed dramatically. In recent years, changes in Federal and state law, including adoption of the Credit Repair Organization Act of 1997 (CROA), have altered the landscape dramatically. Organizations primarily offering credit counseling as a commercial-type service sought to be classified as tax-exempt organizations so that they could charge service fees under exceptions to Federal and state laws available only to tax-exempt charities. As a result, the IRS has found that many credit counseling organizations operating as tax-exempt charities are now primarily sellers of debt-reduction plans, motivated by profit, and offering little or no counseling or education. In many cases, the credit counseling organization also serves the private interests of related for-profit businesses, officers and directors.

Recently, the need to closely scrutinize these organizations increased with the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). This new law requires nonprofit budget and credit counseling organizations to receive certification through the U.S. Trustee Program before providing bankruptcy counseling.

In response to these developments, the IRS initiated a comprehensive, multi-faceted strategy which includes a widespread outreach program to alert the industry and general public to problems in the sector, and a compliance program encompassing both an aggressive examination program to halt abuses within the credit counseling industry and a rigorous determination process to prevent abusive organizations from receiving tax exemption.

## **The Compliance Project – Methodology**

A team, made up of career staff from the Exempt Organizations Division (EO) and IRS Chief Counsel's Office ("the Team"), oversees the strategic management of the Credit Counseling Compliance Project, and coordinates all activities and information relating to examination and determination application processes and outreach.

### **Outreach**

- The IRS has taken significant steps to alert the public, protect vulnerable taxpayers, and put credit counseling organizations on notice that the IRS would not tolerate abuse of tax-exempt status. IRS issued a consumer alert, jointly with the Federal Trade Commission (FTC) and state regulators, warning consumers about questionable activities of credit counseling organizations.
- IRS Commissioner Mark W. Everson testified before both House and Senate Committees regarding IRS actions to help ensure the public is protected from unscrupulous organizations.
- IRS provided speakers on the tax rules relating to non-profit consumer credit organizations for several credit industry conferences.
- IRS met with representatives of the credit card industry concerning "fair share" payment arrangements, and how the credit card industry works with credit counseling organizations.

### **Compliance**

To assist Examination and Determination staff in identifying abuses in the credit counseling industry, the IRS developed a number of training materials.

- A 50-page Continuing Professional Education article for IRS agents that reviewed the law and provided tools for reviewing applications by new credit counseling organizations.
- Chief Counsel Advice CCA 200431023, July 30, 2004, provided structure and legal analysis for assessing cases that include inurement or private benefit.
- An in-depth development letter used by IRS staff to identify problems in applications for tax exemption from credit counseling organizations.

### **Examinations**

The first step in the examination program was to identify the universe of tax-exempt credit counseling organizations to be examined. This was a difficult, multi-step task. IRS coding systems used to identify specific activities had changed over the years. To develop a comprehensive list of organizations, the Team had to apply multiple coding systems and perform several searches within each coding system. Then, to ensure those selected were, in fact, credit counseling organizations, and to secure the names of organizations that had not shown up because they had not been properly coded, the Team took additional steps beyond relying on the coding systems. They performed computerized word searches of IRS database systems of the organization names, such as "credit counsel," "debt manage" or "debt negotiate." By combining these various steps, the Team identified a reliable universe of known tax-exempt credit counseling

organizations.

To determine which organizations within that universe should be examined, the Team looked at issues raised in previously reviewed credit counseling applications and in referrals from other federal and state law enforcement agencies. The Team concluded that certain aspects of an organization's structure, relationship to other entities, and compensation practices were likely predictors of non-exempt behavior.

Once the predictors were identified, the Team manually applied them to the annual information returns (Form 990) of some of the largest credit counseling organizations, based on reported revenues, along with those organizations referred from other federal and state agencies. That review produced a list of 63 organizations identified for examination. The listed organizations represent 56% of the revenues in the identified credit counseling industry, based on the latest available IRS filing data. See attached Summary of Results.

As of the date of this report, the IRS has completed 41 of the 63 examinations. Of these, 9 organizations have had their tax-exempt status revoked or have been terminated, and the rest have received proposed revocations. This represents 41% of the revenue in the identified credit counseling industry, based on the latest available IRS filing data. The examinations completed thus far have uncovered abuses involving credit counseling organizations that: fail to provide education; operate as commercial businesses; and serve the private interests of directors, officers, and related entities. The IRS Criminal Investigation Division has accepted a number of these referrals.

#### **Coordination with Other IRS Offices**

A key factor to the success of the Credit Counseling Compliance Project was the strong support from and coordination with other IRS divisions -- Small Business/Self-Employed, Large and Midsize Business and the Criminal Investigation Division. Experienced staff from these divisions provided investigative support, valuation experience and audit guidelines. Working together, the divisions developed a process to evaluate entities related to credit counseling organizations, such as related for-profit taxable businesses, preparers and individuals. This approach enabled the IRS to recover substantial taxes resulting from inurement and private benefit activities.

#### **Applications for Tax-Exempt Status**

To prevent additional abusive credit counseling organizations from obtaining tax-exempt status, the IRS implemented a rigorous front-end review process to target applications for exemption from organizations conducting credit counseling activities. Under the process, all Form 1023 applications for tax-exempt status were screened to determine whether the applicant is involved in credit counseling activities. Then credit counseling applicants were sent a specifically designed application development letter seeking detailed information about their activities. Initially, responses to these inquiries were reviewed by a "dedicated group" of experienced IRS career staff, in coordination with staff from IRS Chief Counsel's Office, to differentiate compliant organizations from those that appear to be abusive.

As the number of applications increased, it became necessary to increase the number of staff reviewing the applications. To prepare for this change, the dedicated group trained a broader group on relevant issues regarding abusive credit counseling organizations. This training covered the updated procedures, the in-depth development letter, the Core Analysis Tool (see discussion on page 5), sample proposed denials, and sample applications for exemption. To ensure consistency, all proposed denials and recommendations for favorable rulings will be reviewed by the original dedicated group, in coordination with Quality Assurance, for a six-month period.

As noted, the IRS screened all applications for tax exemption from organizations involved in apparent credit counseling activities. Of those applications, 110 appeared to warrant in depth development. Following this development, the IRS issued letters proposing to deny tax-exemption to 37 organizations, 30 of which now have become final denials under our standard procedures. Forty-eight organizations failed to establish exempt status, that is, they failed to provide full responses to questions about their activities. Ten organizations withdrew their applications from consideration after receiving developmental questions from the IRS. Only three credit counseling organizations have met the requirements of section 501(c)(3) and been recognized as tax-exempt. See attached Summary of Results.

## **Going Forward**

The significant level of non-compliance found thus far raises concerns about the remaining universe of credit counseling organizations. To address those concerns, the IRS has:

1. Revised Forms 1023 and 990 to obtain more information about new and existing credit counseling organizations;
2. Issued the attached 2006 Chief Counsel Advice Memorandum explaining whether a credit counseling organization offering counseling and debt management plans to the general public is operating in furtherance of educational purposes;
3. Developed the attached Core Analysis Tool, an audit guide to facilitate expeditious evaluation of credit counseling organizations;
4. Sent all tax-exempt credit counseling organizations not previously selected for examination a compliance check questionnaire seeking information to determine whether they operate compliant credit counseling programs;
5. Established closing agreement procedures to help bring non-compliant credit counseling organizations meeting specific criteria into compliance with the requirements of section 501(c)(3);
6. Instituted follow-up procedures to continue to oversee the credit counseling industry; and
7. Partner with the FTC and EOUST to develop a public awareness program regarding credit counseling organizations.

### **1. Revised Form 1023 and Form 990**

In light of the concerns in the credit counseling industry, the IRS revised two important

exempt organization forms. Revised Form 1023, *Application for Recognition of Tax Exempt Status Under Section 501(c)(3) of the Internal Revenue Code*, seeks information about relationships between the applicant and any for-profit management or servicing entities with which it does business. The revised 2005 Form 990, *Return of Organization Exempt From Income Tax*, requires organizations to disclose whether they provide credit counseling, debt management, or debt negotiation services. This information will help the IRS identify organizations that were not conducting credit counseling services when they applied for exemption, but have begun providing these services since receiving exemption.

## **2. Chief Counsel Advice Memorandum**

The attached 2006 Chief Counsel Advice Memorandum (CCA 200620001, May 9, 2006) provides the legal framework to determine whether a credit counseling organization that offers counseling and debt management plans to the general public operates in furtherance of educational purposes consistent with section 501(c)(3). The Memorandum explains that the manner in which the organization conducts its counseling activities determines whether the organization primarily furthers educational purposes. The way an organization markets its services, interviews clients, develops recommendations, and trains its counselors shows whether an organization's object is to improve a person's knowledge and skills to manage his or her personal debts, rather than offering counseling as a mechanism to enroll individuals in debt management plans without considering the individual's best interest. The Memorandum does not address inurement or private benefit, as those issues were addressed in the initial 2004 Chief Counsel Advice Memorandum (CCA 200431023, July 30, 2004).

## **3. Core Analysis Tool**

To help agents and tax law specialists expeditiously and consistently evaluate whether a credit counseling organization furthers an educational purpose, the IRS developed the attached Core Analysis Tool (CAT) and corresponding CAT Instructions. The CAT is based on the Chief Counsel Advice Memorandum and lists characteristics that demonstrate whether an organization is furthering an educational purpose so that it can meet the requirements of tax exemption under section 501(c)(3). By limiting the focus to factors that indicate whether an organization is furthering educational purposes, the CAT reduces the time and resources necessary for each case. The CAT and Instructions provide guidance during the examination, compliance check or determination process on how to obtain the information needed to complete a thorough analysis of the organization's activities and determine the appropriate resolution to the educational purpose issue.

The critical factors listed in the CAT pertain to: (1) counseling sessions; (2) counselor education and training; and (3) outreach and advertising. For each factor, there are sub-elements that look for specific facts that are to be determined from the examination, the review and development of the exemption application or the response to the compliance check. The CAT and Instructions do not address inurement or private benefit. Where those issues are identified in a case, they are developed consistently with usual examination or determination procedures and with the advice provided in the 2006 Chief Counsel Advice Memorandum (CCA 200620001, May 9, 2006).

By applying the CAT, the IRS will be able to determine whether the organization is furthering an educational purpose, not furthering an educational purpose, or falls somewhere in between. The outcome will determine whether the IRS will:

- Approve or deny an application for tax exemption;
- Close the case with no further action;
- Close the case and issue a written advisory. A “no-change advisory” is issued when an examination or compliance check identifies issues or activities that are insubstantial, but, if conducted to a greater extent, could affect the organization’s exempt status;
- Offer a standardized closing agreement;
- In the case of a compliance check, refer the organization for examination; or
- Revoke the organization’s exemption.

#### **4. Compliance Check Questionnaires**

In addition to examining 63 of the largest credit counseling organizations, the IRS has sent compliance check questionnaires to all of the remaining 743 tax-exempt credit counseling organizations initially not selected for examination to determine whether they operate compliant credit counseling programs.

The questionnaire, which is based on the CAT, and addresses the organization’s most recent closed year of activity, allows the IRS to:

- Educate tax-exempt credit counseling organizations about the requirements for tax exemption under section 501(c)(3);
- Determine whether the organization is conducting credit counseling services in compliance with the tax law;
- Secure delinquent returns or determine that a return is not required to be filed;
- Correct the EO/Business Master File<sup>1</sup> Form 990 or Form 990-PF filing requirements, if a return is not required to be filed; and
- Correct inaccurate EO/Business Master File NTEE<sup>2</sup> Codes, as necessary.

The IRS will assess the questionnaire responses to determine the next appropriate action. For organizations that are compliant, the file will be closed with no further action. For others, the IRS will:

- Issue a written advisory, putting the organization on notice of the applicable legal standard and of areas where it is at risk for noncompliance.
- Offer a closing agreement, or
- Refer the organization for examination.

Organizations that receive favorable decisions, whether in the determination, examination or compliance check process, will receive a customized letter that indicates that as of a certain date the IRS found that their credit counseling activities were

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<sup>1</sup> The Exempt Organization Business Master File (EO/BMF) is a database of all tax-exempt organizations, as well as those organizations that have applied for exemption and been denied.

<sup>2</sup> National Taxonomy of Exempt Entities, a classification system developed by the Urban Institute and the Foundation Center.

consistent with their tax exempt status.

## **5. Closing Agreements**

When an examination or compliance check indicates that an organization is not in compliance, the IRS may, in limited circumstances, choose to resolve the matter with a closing agreement. The IRS will make that offer only where all the facts and circumstances indicate a high likelihood that the organization can implement the necessary remedial action to remain in compliance going forward. All closing agreements will require organizations to:

- Make a payment equivalent to the amount that would have been owed had the organization filed Forms 1120 for the years it failed to qualify for exemption, or enter into a payment arrangement;
- Document how it has changed its activities and demonstrate how it now satisfies the requirement for exemption;
- Consistent with existing requirements for annual information returns, disclose the changes to its operations in the next Form 990 that the organization files, and provide a copy of that form to EO Examination for follow-up; and
- Provide a copy of the closing agreement to the U.S. Bankruptcy Trustee, if the organization applies to the Trustee for certification.

Those organizations entering into closing agreements will receive the same customized letter described in the previous discussion under “Compliance Check Questionnaires.”

## **6. Follow-up Program**

To ensure that tax-exempt credit counseling organizations continue to comply with the law, the IRS has instituted a follow-up program that applies to organizations that enter into closing agreements and receive a written advisory. Under the follow-up program, the IRS will research public records as well as IRS systems regarding an organization and its principals to determine whether the organization is operating inappropriately and/or misrepresenting its tax status.

## **7. Public Awareness**

The IRS is expanding its web site, [www.irs.gov](http://www.irs.gov), to provide helpful information for the public.

- The CAT and Instructions, the Counsel’s Advice Memoranda, Frequently Asked Questions and all other documents attached to this Report are posted on the IRS web site. This information alerts the public and credit counseling organizations to the criteria and legal framework the IRS is using to evaluate whether an organization operates for tax-exempt educational purposes. Using the criteria, a credit counseling organization can make changes to its operations to ensure it is in compliance with the tax laws.
- The IRS recently added a new feature to [www.irs.gov](http://www.irs.gov) which helps the public identify organizations that no longer qualify to accept tax deductible contributions. Credit counseling organizations that fall under this category are included on the list.

In the near future, the IRS will unveil a website to help consumers navigate this difficult area. Partnering with other stakeholders (e.g., FTC, Department of Justice’s Executive

Office of the U.S. Trustee (EOUST)), the website will contain links and other information for consumers regarding credit counseling organizations. While consumer education is generally outside the IRS responsibilities, in this case, the IRS believes it is advisable given that its enforcement activities are reaching the entire industry.

The IRS continues to work with other government agencies to combat abuses in this industry. In addition to the on-going coordination with the FTC, the IRS is working with the EOUST regarding its implementation of BAPCPA, the bankruptcy law. The IRS is requiring all credit counseling organizations that enter into a closing agreement with the IRS to provide a copy of the agreement to EOUST if the organization applies to that Office for certification.

## **Conclusion**

The Credit Counseling Compliance Project addresses potential abuse of tax exemption by credit counseling organizations. This comprehensive program involves coordination with other federal and state agencies and oversight organizations to combat abuses, provides the public and the industry with several guidance and educational documents describing the hallmarks of an acceptable credit counseling program, and maintains continuous oversight of the tax-exempt credit counseling industry.

### **Attachments:**

- Chief Counsel Advice Memorandum (CCA 200620001, May 9, 2006)
- Core Analysis Tool and Instructions
- Compliance Check Questionnaires
- Summary of Results
- Frequently Asked Questions
- Application Development Letter